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Domestic suppliers, consumer
groups, other interested parties

Email: retailpriceregulation@ofgem.gov.uk

Date: 7 August 2019

Dear stakeholder,

Decision: approach to the third cap period for the default tariff cap

On 18 June, we published a consultation on our approach to setting the default tariff cap level for the third cap period for the default tariff cap (the 'June consultation').[1] This consultation related to two elements where we needed to determine our approach for this cap period. These were: the allowance for the net costs of the smart meter rollout, and the allowance for the costs of the Capacity Market (CM).

In summary, we have decided to maintain our proposals in both areas.

- We have set the non-pass-through Smart Metering Net Cost Change (SMNCC) component for the third cap period using our current non-pass-through model. This is the same model that we used to set the non-pass-through SMNCC for the first two cap periods.
- We have included a full CM allowance in the third cap period. This allowance covers the costs associated with the CM Supplier Charge, as well as the administrative costs of the CM scheme.

The third cap period will run from 1 October 2019 to 31 March 2020. We have announced the level for the third cap period today (7 August 2019), in line with the requirements in the licence.[2] The level we have announced takes into account this decision document.

We received six non-confidential responses to our consultation. We have uploaded these responses to our website, on the same page as the June consultation. We are grateful to these stakeholders for taking the time to respond.

In the remainder of this decision, we summarise the feedback stakeholders provided and give our responses where relevant. We also confirm the detail of our decision as it affects the models we use to calculate the cap.

[1] Ofgem (2019), Default tariff cap: approach to the third cap period.
https://www.ofgem.gov.uk/system/files/docs/2019/06/default_tariff_cap_june_consultation.pdf
[2] Standard licence conditions 28AD.19 of the electricity supply licence and 28AD.18 of the gas supply licence.

The consultation followed on from our earlier consultation on our general approach to reviewing smart metering costs (the 'April consultation'), which included material on the third cap period.[3]

Smart metering

Feedback summary

All consultation respondents agreed with our proposal to set the non-pass-through SMNCC component for the third cap period using our current non-pass-through model.

One respondent welcomed our confirmation that the non-pass-through SMNCC values for gas and electricity had been incorrectly transposed in our April consultation.

One respondent welcomed the transparency provided about our proposal to correct an error. (This was a formula error in the calculation of DCC costs). It said that it would welcome clarity about the magnitude of this error.

All respondents said that they did not support the proposal from our April consultation to give regard to any substantial advance payment (or lagged payment) in the first three cap periods when setting the SMNCC for the fourth cap period and beyond.[4] Two respondents said that their support for our third cap period proposal was subject to Ofgem not giving regard to this allowance when calculating the allowance for later cap periods.

One respondent noted the Competition and Markets Authority's (CMA's) provisional decision not to include a non-pass-through SMNCC in the revised prepayment meter (PPM) cap. It said that it understood the default tariff cap SMNCC is calculated based on the costs and number of meters across both credit meters and PPMs. This would mean that not including a non-pass-through SMNCC in the PPM cap would lead to an under recovery of smart metering costs. It said that we should either: uplift the SMNCC so that suppliers fully recover all smart metering costs, or make an interim adjustment for the third cap period to focus the SMNCC calculation on credit meters rather than meters in general.

Respondents raised a number of points which went beyond the calculation of the SMNCC for the third cap period. These often covered similar issues as those raised in response to the April consultation. The most frequent issues raised were: further data gathering, disclosure of the SMNCC model, and contingency plans should the publication of the BEIS CBA be delayed.

Our decision

We have decided to use our current non-pass-through model to set the SMNCC for the third cap period. Our rationale is unchanged from our June consultation. The alternative option of taking no action would mean that there would be no non-pass-through SMNCC in the third cap period. This could constrain the rollout of smart meters, as there would not be an allowance to provide suppliers with revenues to cover the incremental costs of installing smart meters. Given this, we have decided to use the information currently available to us (ie the current non-pass through SMNCC model) to set the non-pass-through SMNCC for the third cap period.

As set out in our June consultation, we will continue to consider our approach for reviewing efficient costs and setting the allowance in cap period four and beyond. We will publish our proposals and update stakeholders on our thinking at a later date, and we will take into

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3 Ofgem (2019), Reviewing smart metering costs in the default tariff cap.
https://www.ofgem.gov.uk/system/files/docs/2019/04/review_of_smart_metering_costs_in_the_default_tariff_cap.pdf

4 Ofgem (2019), Reviewing smart metering costs in the default tariff cap, paragraphs 4.19 and 4.20.
https://www.ofgem.gov.uk/system/files/docs/2019/04/review_of_smart_metering_costs_in_the_default_tariff_cap.pdf

account feedback already received. For the avoidance of doubt, our decision for the third cap period does not fetter our discretion to adopt any particular approach for the fourth and subsequent cap periods.

We calculate the SMNCC based on the costs for, and number of, credit meters. This is because these meters are in scope for the default tariff cap. The SMNCC therefore already recovers the costs for credit meters, and so we do not need to make an interim adjustment as suggested by one respondent (see above). More generally, we do not intend to use the SMNCC in the default tariff cap to recover any costs for the PPM customers who are currently out of scope for the default tariff cap.

We have decided to correct the formula error in the calculation of DCC costs. As an illustration of the magnitude of this error, it was worth approximately £0.41 for a typical dual fuel customer paying by direct debit in the second cap period.[5]

Our June consultation related solely to the third cap period. As set out in our June consultation, we will respond to the remaining issues raised in our April consultation through our subsequent publications. We will also use these publications to respond to the remaining issues raised in response to our June consultation, given that many of these were the same.

Detail of decision

To implement our decision, we have included non-pass-through SMNCC values for the third cap period in the document Annex 5 referred to in the cap licence conditions.[6] We have inserted values in cells J7 and J8 of sheet '2a Non pass-through costs'. These values are £9.26 for electricity and £11.24 for gas.[7] We have calculated these values using our current non-pass-through SMNCC model.

For the third and subsequent cap periods, we have also corrected an error within the current pass-through SMNCC model. The total DCC costs did not include the total dual band communications hub costs. This applied to both gas and electricity. We have addressed this by editing the formulas for 'Total Explicit Costs' in rows 52 and 53 of sheet '2c DCC' of Annex 5. When correcting this error, we have only edited the values for the upcoming cap periods (ie the third cap period and onwards), which are in columns M to U. We have not edited the formulas for past cap periods, so that the model continues to reflect the actual levels in previous cap periods. For electricity, we have added to the sum the relevant cell in row 48 ('Total DB Comms Hub Costs – Electricity'). For gas, we have done the same in relation to row 49 ('Total DB Comms Hub Costs – Gas').

Capacity Market

Feedback summary

All consultation respondents agreed with our proposal to include a full CM allowance in the third cap period, covering the costs associated with the CM Supplier Charge, as well as the administrative costs of the CM scheme.

One respondent referred to the possibility that the State Aid decision was published before 7 August. It said that timescales were tight, and that it was therefore important for us to work closely with the Department for Business, Energy and Industrial Strategy, so that we were able to incorporate any last minute developments.

[5] This figure includes the consequential impacts on the payment method uplift, Earnings Before Interest and Tax, and headroom terms, as well as the increase in the SMNCC itself. This figure includes VAT.
[6] Standard licence condition 28AD of the gas and electricity supply licences – specifically SLC 28AD.10, 28AD.14 and 28AD.15 for gas, and SLC 28AD.11, 28AD.15 and 28AD.16 for electricity.
[7] This is as published in our June consultation, correcting the incorrect transposition of these figures in our April consultation.

Two respondents noted the CMA's provisional decision to adopt the default tariff cap methodology in relation to the CM allowance for its PPM cap. They also noted the possibility that the CMA did not proceed with this decision (at least in time for the next cap period). In this situation, one respondent said that we would need to have regard to our statutory duties to ensure suppliers can finance their licence obligations, and one respondent said that we and the CMA should ensure that suppliers could fully recover CM costs.

In our June consultation, we set out our proposal to include actual data on the results of the replacement T-1 auction (rather than the estimates used for the second cap period). One respondent said that it supported the use of actual data to set the third cap period allowance.

Our decision

We have decided to include a full CM allowance in the third cap period. This allowance covers the costs associated with the CM Supplier Charge, as well as the administrative costs of the CM scheme.

Our rationale is unchanged from our June consultation (and our decision for the second cap period).[8] We consider that we should set the cap to enable suppliers to collect CM costs from their customers. This will enable suppliers to ultimately pay for deferred payments to capacity providers, should there be State Aid approval for this. As noted previously, in the event that State Aid approval for deferred payments is not granted, we expect suppliers to reimburse consumers. We do not consider that there have been any developments since our February decision which change this position. We are still awaiting a State Aid decision.

We note that for the PPM cap, the CMA has published its decision which adopts the CM allowance component of the default tariff cap methodology.[9]

Detail of decision

We have updated the inputs to the document Annex 2 referred to in the cap licence conditions,[10] as set out in the licence, and used the model to calculate the CM allowance.

We have included the outcome of the replacement T-1 auction, which was held on 11 and 12 June 2019. The calculations for the second cap period used placeholder values, given this auction had not taken place at that point. We are now able to use the actual clearing price and obligated capacity to calculate the allowance for the third cap period. These values are available in the provisional auction results.[11]

- For obligated capacity, we entered 3,626.196MW in cell S48 of sheet '6b Obligated capacity'.
- For the clearing price, we entered £0.77/kW/year in cell C23 of sheet '6c Clearing prices and CPI'. Given the auction is held in the same year as delivery, there is no need to index this clearing price for inflation. We have therefore entered "N/A" as the CPI base period in cell E23.

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8 Ofgem (2019), Decision: capacity market allowance in the default tariff cap. https://www.ofgem.gov.uk/system/files/docs/2019/02/decision_-_capacity_market_allowance_in_the_default_tariff_cap.pdf

9 Competition and Markets Authority (2019), Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016. https://www.gov.uk/cma-cases/review-of-the-energy-market-investigation-prepayment-charge-restriction-order-2016
There are still other differences between the default tariff cap methodology and the revised PPM cap methodology.

10 Standard licence condition 28AD of the gas and electricity supply licences – specifically SLC 28AD.7, 28AD.14 and 28AD.15 for gas, and SLC 28AD.8, 28AD.15 and 28AD.16 for electricity.

11 National Grid Electricity System Operator (2019), Provisional Auction Report – 2018 year ahead Capacity Auction (T-1), 12 June 2019.
https://www.emrdeliverybody.com/Capacity%20Markets%20Document%20Library/Provisional%20Results%20Report%20T-1%202018%20(DY%2019-20).pdf

Given the small amount of capacity procured through the T-1 auction, this auction only has a small impact on the CM allowance for the third cap period.

Yours faithfully,

Anna Rossington
Deputy Director, Retail Price Regulation